In the Supreme Court of the United States

OCTOBER TERM, 1964

No. 489

UNITED STATES OF AMERICA, PETITIONER

v.

ATLAS LIFE INSURANCE COMPANY

ON WRIT OF CERTIORARI TO THE UNITED STATES COURT OF APPEALS FOR THE TENTH CIRCUIT

REPLY BRIEF FOR THE UNITED STATES

I

The respondent and the *amici* have urged that Congress did not intend, in 1959, to reduce the incentive of life insurance companies to buy tax-exempt bonds, and that therefore the "exception" provisions of the 1959 Act should be construed in a way that wholly vitiates the allocation formula of the same Act. We challenge the representation that our interpretation reduces the incentive in comparison with the 1942 statute. The fact of the matter is that the enactment of the 1959 statute increased, rather than reduced, the incentive of life insurance

768-356—65

companies to buy tax-exempt bonds. Congress was fully informed, prior to the enactment of the statute, that this would be its likely effect. History has demonstrated the accuracy of that prediction.

Mr. David Lindsay, Assistant to the Secretary of the Treasury, informed the Senate Committee by memorandum that (*Senate Hearings* at p. 50):

> Since the effective rate of tax under H.R. 4245 is generally higher than under present law (with exceptions and variations depending upon the circumstances of individual companies) the value of the tax-exempt feature of municipal securities in the hands of life insurance companies would generally be greater under the bill than under present law. The attractiveness of municipal securities to life insurance companies as a whole should accordingly be enhanced and the market for such securities to that extent should be greater.

His prediction has proved true to a rather dramatic extent.

Respondent and the *amici* have referred to statistics found in the *Life Insurance Fact Book of 1964*, a publication of the Institute of Life Insurance. The following chart is complied from pages 65 and 73 of the *Fact Book*, and shows that the life insurance industry's holdings of tax-exempt State bonds increased radically in the five calendar years ending after the enactment of the 1959 Act (on June 25, 1959). The increase is equally dramatic whether measured in terms of total volume of holdings, percentage increase in volume of holdings, or percentage increase in the

share of the industry's assets held in the form of municipal bonds.

Year	Total assets of United States life insurance companies at end of calendar year	Total dollar amount of State bonds owned by United States life insurance companies	Percentage of assets held in form of State bonds
1954	$84,486,000,000	$1,846,000,000	2.2
1955	90,432,000,000	2,038,000,000	2.3
1956	98,011,000,000	2,273,000,000	2.4
1957	101,309,000,000	2,376,000,000	2.3
1958	107,580,000,000	2,681,000,000	2.5
1959	113,650,000,000	3,200,000,000	2.8
1960	119,576,000,000	3,588,000,000	3.0
1961	126,816,000,000	3,888,000,000	3.1
1962	133,291,000,000	4,026,000,000	3.0
1963	141,121,000,000	3,852,000,000	2.7

The average of life insurance company holdings of State bonds for the five years ending before the enactment of the 1959 Act is $2,242,800,000. For the five years following enactment of the statute, the average increased by almost one and one-half billion dollars to $3,710,800,000. This change represented a 65-percent increase in the holding of municipal bonds over a five-year period while total assets increased only 32 percent (from an average of $95,964,000,000 to an average of $126,891,000,000). During the same years, the portion of assets held in State bonds increased by approximately 26 percent from 2.3 percent to 2.9 percent. While this increase in bondholdings was, to a large extent, a continuation of a gradual process begun before 1959, the statistics rather plainly show a significantly accelerated increase beginning in that year.

Mr. Lindsay's accurate prediction was based on a comparison of the 1942 taxing statute with the 1959

Act. See *Senate Hearings* at 50. Under the 1942 Act, an insurance company was allowed a reserve deduction equal to a fixed percentage of its net *taxable* income. 56 Stat. 867–870. In the years from 1942 to 1957 the deduction was always in excess of 85 percent of taxable income, generally in excess of 90 percent, and, for two years, was 100 percent. See Wurzel, *Tax Exempt Interest of Life Insurance Companies*, 70 Yale L. J. 15, 20–21. The result was that a life insurance company generally had no reason to shift a larger part of its investment to the tax-free, lower-return municipal bonds in place of other taxable, higher-return securities. For example, a company deciding between a corporate bond paying 4.5 percent and a municipal bond paying 3.5 percent would realize that it would be allowed a reserve deduction of approximately 90 percent of the return on the corporate bond, but no reserve deduction on the municipal bond. It would be left with an *after-tax* return of over 4 percent on the corporate bond in contrast to the 3.5 percent after-tax return on the municipal bond. In short, since the reserve deduction under the 1942 Act was a fraction of *taxable* income, a taxpayer could gain the 100-percent exemption of interest from State bonds only by giving up the 90-percent reserve exemption of income from corporate stock or bonds.

The situation under the 1959 Act is, in principle, identical. An insurance company is allowed a reserve exemption measured by a percentage—usually quite high—of its taxable investment income. Just as under the 1942 Act, an insurance company can obtain

the benefits of 100-percent tax-free State bonds only by foregoing the advantage of the high percentage exemption from tax (in this case 87.4 percent) of the return from taxable securities.

The only difference between the 1942 Act and the 1959 Act is the method of computing the percentage of taxable income which is entitled to a reserve exemption. The percentage was determined under the 1942 Act on an industry-wide basis by a statutory formula; it was reduced by the industry holdings of tax-exempt bonds, but still generally resulted in an exceedingly high reserve deduction. Under the 1959 Act the percentage is determined on a single-company basis by dividing each company's total investment income (taxable and tax-exempt) into its reserve requirements. The enactment of the 1959 Act could deter the purchase of State bonds only if the percentage of taxable income allowed a reserve exemption from tax proved greater under that Act than under the 1942 Act. In light of the extraordinarily high percentages arrived at under the 1942 Act, this appeared unlikely from the start. In fact, the 1959 Act has apparently increased the incentive to buy tax-exempt bonds, by reducing for most companies the reserve exemption of taxable income. The result has been the remarkable increase in holdings of State bonds, which is revealed by the above chart, taking place during a period when the life insurance companies have assumed the applicability of the statutory allocation formula. The present case, initiated almost three years after the enactment of the 1959 Act, marks

the first occasion when any company has challenged the applicability of that formula.

Two conclusions follow, both directly contradictory of respondent's representations:

First, there was nothing novel in limiting the deduction for the addition to the reserve to the portion of the actual addition reflecting the extent of investment in taxable securities. This has been accomplished since 1942 by making the reserve deduction a fraction of an insurance company's taxable income, thus reducing the deduction to the extent the company's investments are in tax-exempt bonds rather than taxable securities.

Second, the 1959 Act did not adversely affect the insurance companies' demand for tax-exempt bonds.[1]

II

A. Respondent contends that the proper method by which to determine whether the apportionment formula imposes a tax on its tax-exempt interest is to compare its tax determined under the formula with what its tax would have been if it had not received

[1] Both respondent and the *amici* have exercised remarkable selectivity in referring to the figures for insurance company holdings of State bonds. *Amici* first suggest a downtrend in the portion of company assets invested in State bonds by comparing year-end figures for 1963 with those for 1959 (Am. Br. 16, n. 1), ignoring the facts: (1) that both dates are well after, and reflect the effects of, the enactment of the 1959 Act in June 1959; (2) that on December 31, 1960, 1961, and 1962, the share of investments was substantially higher than on December 31, 1959; and (3) that for *each* of the five years after enactment of the 1959 Act, the share was significantly greater than for *any* of the five years preceding enactment. Respondent avoids these difficulties only because it mistakenly attributes the December 31, 1959

the interest. To make the required hypothetical determination, it is necessary to make assumptions about respondent's assets, liabilities, and other income which are consistent with its not receiving the tax-exempt interest. There would be fatal defects in the test, as we have shown in our opening brief, even if respondent's assumptions were correct. We content ourselves here with showing, as an additional point, that in fact the assumptions made by respondent, we will show, are wholly unrealistic, with the consequence that the comparison made by respondent provides a purely fanciful standard by which to determine the incidence of the tax.

Respondent had tax-exempt interest of $36,637, which, for the sake of round numbers, we will assume was produced by an investment of $1 million in municipal bonds. It acquired that $1 million to invest by selling life insurance policies, thereby incurring liabilities to policyholders the annual increase in which is the annual "cost" of the use of that money. If, in making the hypothetical determination required by respondent's argument, it is to be assumed that

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figures to December 31, 1958 (Br. 56, n. 38). In December 1958, 2.5 percent—rather than 2.8 percent—of the companies' assets were in State bonds.

The most remarkable selection of figures, however, is found in the *amici's* comparison of the share of life insurance company assets invested in State bonds in 1940 with that in 1963 (Am. Br. 16, n. 1; 50, n. 2). Whether as a result of the wartime conditions of the securities markets or of enactment of the 1942 Act, company percentage holdings of State bonds plummeted from an all-time high in 1940 of 6.8 percent to an all-time low in 1947 of 1.2 percent. For the last fifteen years there has been a continuing increase in the share of company assets held in the form of State bonds.

respondent did not receive the $36,637 of tax-exempt interest, what is to be assumed about the $1 million of its assets it had invested in municipal bonds and about the liabilities to policyholders it had incurred to obtain the use of that money? There are at least three possible sets of assumptions that might be made to reconcile respondent's assets and liabilities with the assumed non-receipt of the tax-exempt interest:

(1) It might be assumed that respondent sold the same number of policies, incurred the same liabilities to policyholders, and had the same total assets, but invested the $1 million in taxable securities rather than in municipal bonds. In that event, even if it received no more income from the taxable securities than from the municipal bonds, its tax would have been greater, not less, than in the actual case.

(2) It might be assumed that respondent sold fewer policies, had correspondingly smaller liabilities to policyholders, and simply had $1 million less in total assets. In that event, respondent's taxable items of income would have been the same, but the deduction or exclusion for the required addition to the reserves would have been proportionately smaller, producing a tax liability substantially the same as that produced by the allocation formula in the actual case.

(3) It might be assumed—and this is what respondent does assume in its calculation—that respondent sold the same number of policies, incurred the same liabilities to policyholders, had the same total assets, but simply held $1 million of its assets in idle cash. It is only on that assumption that respondent's tax would have been less than that produced by the allocation formula.

The facts assumed by respondent to determine what its tax "would have been" had it not received the tax-exempt interest—the third assumption—are, it may be seen, wholly improbable as a matter of economic experience. A life insurance company does not incur liabilities to policyholders to obtain the use of their money simply in order to hold the money as idle cash, and a company which did so would soon be bankrupt. Realistically, the choice is between investing the money in municipal bonds *or* investing it in taxable securities. Moreover, in the unlikely event that a company did decide to reduce its total investments (*i.e.*, to reduce its holdings of municipal bonds but not increase its holdings of taxable securities), rationality would require it, rather than to hold idle cash, to undertake to reduce its liabilities to policyholders commensurately—*i.e.*, by not selling new policies to replace those cancelled or extinguished by payment of benefits. Thus the only assumptions consistent with the facts of economic life are the first two possibilities given above. If, then, the incidence of the tax is to be determined by comparing the tax with what the tax would have been without the tax-exempt interest, the hypothetical determination can meaningfully be made only by employing one of the first two assumptions. And on either of those assumptions, the fact is that respondent's tax would have been as great (on the second assumption) or greater (on the first assumption) without the tax-exempt interest as it was with it.

B. The comparison made by respondent is not only unrealistic but it is also precisely the comparison that

was rejected by this Court in *Deuman* v. *Slayton*, 282 U.S. 514, sustaining a disallowance of a deduction for interest paid on borrowed money that was invested in municipal bonds. It is simply not true, as *amici* state—except in the same sense that it is true here—that the taxpayer in that case "would not have had to pay [the interest] if he had not bought the bonds". (Am. Br. 28; see also Resp. Br. 45–46). He would not have had to pay the interest if he had not borrowed the money, but he *could* have borrowed the money, not bought the bonds, and simply held the money as idle cash, in which event he not only would have had to pay the interest but would have been entitled to deduct it. To be sure, it would be economic suicide for a taxpayer to borrow money, pay interest on it, and then not invest or otherwise use it. But just so would it be economic suicide for a life insurance company to incur liabilities to policyholders to obtain the use of their money and similarly fail to invest it. The assumption upon which the Court proceeded in *Denman* v. *Slayton* was that the taxpayer would have acted rationally and hence that, if he had not bought the bonds, he would not have borrowed the money in the first place. The equivalent assumption that must be made in this case is that, if respondent had not wanted to invest the $1 million, it would not have incurred additional liabilities to policyholders in order to obtain the use of the money in the first place.

The point is that the reserve addition "expense" involved in this case was just as much a marginal cost of holding the municipal bonds as was the interest expense in *Denman* v. *Slayton*. It is simply not true, as respondent asserts (Br. 46), that the reserve addition was a "fixed" expense that would have been incurred in all events. The level of a life insurance company's reserve liabilities is fully within its control and is determined simply by how much money the company wants to have available for investment. Nor is that true only historically, for the level of the reserve liabilities (and hence the amount of the required addition to the reserve) is affected to a significant extent by the company's actions in each taxable year: if it did not continue each year to sell new policies to replace those cancelled or extinguished, both its assets and its reserve liabilities would decline. Thus respondent specifically chose—by selling policies—to incur an additional reserve-addition "expense" in order to have available for investment the $1 million which it invested in municipal bonds. That additional expense, which it might have avoided by reducing its outstanding policies, was thus a marginal expense of holding the municipal bonds in precisely the same sense as was the interest expense in *Denman* v. *Slayton*—it was the cost, which would not otherwise have been incurred, of obtaining the use of

the money which respondent chose to invest in municipal bonds.[2]

Respectfully submitted.

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[2] In emphasizing that the addition to the reserve is in fact a marginal expense, we do not mean to suggest that a different result would follow if the addition were a fixed cost. In our original brief we showed that, when a fixed expense is attributable both to the cost of producing taxable income and to other purposes, it is proper to apportion the expense between its purposes and to allow a deduction only for that part of the expense properly allocable to the production of taxable income. It makes no difference whether the expense is the fixed cost of annual dues paid a country club which is used for both business and personal purposes (see Section 262 of the 1954 Code) or whether the expense is the cost of producing both taxable and tax-exempt income (see Section 265(1) of the 1954 Code). That is the holding of *Helvering* v. *Independent Life Ins. Co.*, 292 U.S. 371, which, in turn, relied upon *Denman* v. *Slayton*, 282 U.S. 514. It would fully dispose of the present case even if the reserve expense—the cost of using the reserve funds—were a fixed charge, allocated between the costs of producing taxable and tax-exempt income for the company.

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